Issue 11a: **Which of the changes discussed in Section IV.B. herein, if any, should be predicated on a demonstration that certain barriers to entry have been removed, and why? If such a demonstration should be required, should a competitive checklist be used and, if so, what should be included in it? Are there any other tests for the existence of competition that should be used to determine whether regulatory relief and pricing flexibility should be granted? Should any of the proposed changes to our price cap rules be predicated on a demonstration of actual competition or upon some other circumstances and, if so, why?**

Issue 11b: **In addition to adopting a "competitive checklist", are there other steps that need to be taken to ensure competition in the interstate access market. For example, is it necessary for the LECs to separate local bottleneck facilities, such as loops and switching, through a separate subsidiary, and to provide these facilities to all access providers at "wholesale prices"?**

3. Procedural Matters

111. As discussed above, we are contemplating modifying the price cap plan in various ways when a LEC can show the existence of certain competitive circumstances in a relevant part or parts of its service region. In this section, we seek comment on the procedures with which the LECs should comply when making these showings.

112. Ideally, the procedural mechanism we adopt would create little or no administrative burden on the Commission, price cap LECs, or other interested parties. Specifically, the required showing should be relatively simple for the LEC to make, while still enabling us and other interested parties to determine relatively quickly that the LEC has in fact met the criteria for the regulatory relief it seeks.

113. One possibility would be to require the carrier to submit a separate filing, prior to filing tariffs, showing that the conditions it faces warrant the relief it seeks. We have a number of options to use as a procedural mechanism for this separate filing, such as waiver requests or petitions for declaratory rulings. If we adopt any regulatory relief based on a checklist as proposed above, we could permit that relief on the basis of a certification letter. Under this approach, the LEC would submit a letter showing that it has met all the criteria spelled out in the checklist, and the relief would be granted automatically unless the Common Carrier Bureau denies certification within a specified period of time. An example of another kind of procedure would be the procedure followed in establishing zone density pricing plans. In that procedure, the LECs were required to submit plans which showed that the assignment of each of their central offices into a zone reflected some cost-related

characteristics, such as traffic density or some measure of traffic through each office, which were reviewed and approved by the Common Carrier Bureau.[163]

114. Another possibility would be to permit carriers to seek regulatory relief in the context of a tariff filing. This procedure is not optimal, however. In the *First Report and Order*, for example, we found that permitting carriers to seek exogenous treatment for certain categories of cost changes in tariff filings makes the tariff review process cumbersome and subject to manipulation.[164] We would prefer the tariff review process to focus on the issues for which it was designed, such as compliance with cost support requirements.

115. We invite comment on these procedures, and invite parties to propose other procedural methods for LECs to seek the proposed relaxed regulatory relief or additional pricing flexibility within price caps. Commenters should explain why they believe that the procedure they advocate would permit us and other interested parties to determine that the carrier does in fact face the conditions that we have decided warrant some regulatory relief. Parties should also discuss why they believe the procedures they advocate are less administratively burdensome than other procedures that might be used for this purpose.

Issue 12: What is the best procedural mechanism for price cap LECs to use when seeking regulatory relief or pricing flexibility within the price cap plan?

D. Relevant Markets

1. Introduction

116. As we pointed out in Part A, several of our proposals may require us to evaluate the competitiveness of specific markets. To make such determinations, it is necessary to define "the relevant market." A relevant market is typically defined to encompass commodities that are easily substituted for each other and may be verified by measuring the cross-elasticities of demand.[165] A high, positive cross-elasticity of demand indicates that purchasers can easily substitute another product or service when the incumbent provider increases its prices. As an example of an approach to defining the relevant market,

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[163] *See, e.g.*, *Special Access Expanded Interconnection*, 7 FCC Rcd at 7454-55; BellSouth Telecommunications, Inc., *et al.*, Zone Density Pricing Plans, 8 FCC Rcd 4443 (Com. Car. Bur. 1993)(*LECs' Zone Density Pricing Plans*).

[164] *First Report and Order*, para. 315.

[165] Cross-elasticity measures the changes in demand (or supply) of commodity X when the price of commodity Y changes. A positive cross-elasticity indicates that the commodities are substitutes.

the Department of Justice/Federal Trade Commission Horizontal Merger Guidelines (Merger Guidelines) define a relevant market as:

> (A) group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm . . . that was the only present and future producer or seller of the products in that market likely would impose at least a "small but significant and nontransitory increase in price . . . ."[166]

Under the Guidelines, once a properly-defined market is identified, current market participants are identified. To this list are added "uncommitted entrants", or firms which would be likely to enter "within one year and without the expenditure of significant sunk costs of entry and exit, in response to a 'small but significant and nontransitory' price increase."[167] We propose and seek comments below on an operational model for defining the relevant product and geographic markets in access service. The model must be tailored to provide generally applicable definitions of relevant product and geographic markets that can serve as base units for evaluating competition in access markets.

2. Relevant Product Market

117. Conceptually, the product market can be defined in two ways. One method that is frequently used in competitive analyses is to rely on the judgment of industry experts.[168] The alternative approach is to use formal econometric studies that measure long-run cross-elasticities of either supply or demand. We believe that market definitions based on judgment are sufficiently useful for evaluating access services and that the existing services categories and subcategories described above are both acceptable and useful. We observe that they were initially developed after consideration of cross-elasticity,[169] and we believe that the fundamental relationships are generally unchanged. Furthermore, the existing definitions are well accepted and understood. We believe that the single product market which was defined for interstate services of the IXCs[170] is not the appropriate product market definition for the services of the LECs.

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[166] Merger Guidelines, at 4.

[167] Merger Guidelines, at 11.

[168] *Modern Industrial Organization* at 806.

[169] *LEC Price Cap Order*, 5 FCC Rcd at 6711 (para. 203); *BNA Order*, 8 FCC Rcd at 4483 (para. 24).

[170] Common Carrier Services, 95 FCC 2d 554, 562-63 (1983)(*Common Carrier Services*), *rev'd on other grounds sub nom.*, AT&T v. FCC, 978 F.2d 727 (D.C. Cir. 1992)(*AT&T v. FCC*).

118. We therefore propose to define the relevant product market using existing definitions of current service categories within each access service baskets. Under Parts 61 and 69 of the Commission's Rules, LEC interstate services are divided into common line, traffic sensitive, trunking, and interexchange baskets of services. Within the traffic sensitive basket, there are four services categories: (1) local switching; (2) information; (3) data base access; and (4) billing name and address. The seven categories of the trunking basket are (1) voice grade flat-rate transport, voice grade special access, WATS, metallic, and telegraph; (2) audio and video; (3) high capacity and digital data services ("DDS"); (4) wide band data and wide band analog; (5) tandem-switch transport;(6) the interconnection charge; and (7) signalling for tandem switching. Within the high capacity-DDS service category, there are two sub-categories: (a) DS1 special access and DS1 flat-rate transport; and (b) DS3 special access and DS3 flat-rate transport.[171] In addition to the price cap baskets, service categories, and subcategories, there are various rate elements (billing elements) that are associated with specific costs and/or functions of LEC interstate services. We seek comments on using these access service definitions for defining the relevant market for purposes of determining whether to grant additional pricing flexibility or other regulatory relief within the LEC price cap plan, as well as in streamlining and non-dominance determinations.

Issue 13: Should we use the existing price cap service categories within the baskets to define the relevant product market?

119. If alternative definitions are proposed, parties should provide support for their proposals. Parties also should comment on the use of econometric studies to estimate cross elasticities in defining markets and should provide studies that define homogeneous access services.

3. Relevant Geographic Market

120. We propose to define the geographic market for access services using the density zones developed by LECs for the provision of expanded interconnection service.[172] It is likely that demand and supply elasticities in a particular geographic area served by a given LEC will differ from the demand and supply elasticities in other geographic areas served by it or another LEC. This implies that a single national market, which was defined for interstate services of the IXCs,[173] is not the appropriate geographic market definition for the services of the LECs. The relevant geographic market must be narrow enough to only encompass competing access services for the same set of customers, yet be broad enough to

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[171] Section 61.42 of the Commission's Rules, 47 C.F.R. § 61.42(e).

[172] *See, e.g., Special Access Expanded Interconnection*, 7 FCC Rcd at 7454-55 (paras. 179-80); *LECs' Zone Density Pricing Plans*, 8 FCC Rcd 4443.

[173] *Common Carrier Services*, 95 FCC 2d at 562-63, *rev'd on other grounds sub nom., AT&T v. FCC*.

be administratively workable. Defining the relevant geographic market incorrectly will misstate competition. We believe that density-based zones of the kind adopted in the expanded interconnection proceeding generally reflect the individual markets for access services.

121. When we adopted the expanded interconnection rules,[174] we permitted LECs to establish three or more pricing zones for special access services within each study area, based primarily on traffic density.[175] We subsequently permitted LECs to establish zone density pricing for switched transport services as well.[176] We required the LECs to file and obtain approval of their zone density pricing plans. In filing a proposal, the LECs must assign each central office in a study area to a zone. The LECs must make a showing that the assignment of central offices to each of the zones reflects cost-related characteristics, such as traffic density or some measure of traffic through each office. Geographic contiguity may also be considered as well as communities of interest, but these are less important factors in establishing the pricing zones than traffic density.[177] LECs are permitted to redefine one or more central offices from one zone to another.[178]

122. The pricing zones with the highest traffic density are designated as Zone 1. Because they tend to serve high-volume customers, Zone 1 offices generally represent a disproportionately large level of switched minutes of use and central office equipment investment. These high densities make Zone 1 offices the most attractive areas for entry by competitors and, therefore, may represent the geographic markets in which the LECs are most likely to take advantage of the pricing flexibility we are proposing herein.

123. As noted earlier, we have permitted LECs to geographically deaverage their rates in response to competitive pressure on a limited basis,[179] and are considering a pending

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[174] *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7451-55.

[175] The LECs are required to provide additional justification to establish more than three zones and such proposals are subject to greater scrutiny by the Commission.

[176] *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7426-27 (paras. 98-101).

[177] *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7451-55.

[178] *See* GTE Service Corporation, Revised Zone Density Pricing Plan, 10 FCC Rcd 5696 (Com. Car. Bur. May 2, 1995).

[179] *Special Access Expanded Interconnection Order*; *Switched Transport Expanded Interconnection Order*; *NYNEX Universal Service Waiver Order*.

request for some further limited geographic deaveraging in another proceeding.[180] We believe that if we condition the regulatory relief and pricing flexibility discussed in Section IV.B. on a showing of competitive conditions in a geographic market smaller than a study area, then the relief and flexibility should only be given in that geographic market within which the competition exists. We recognize that this will further expand the number of instances in which we currently permit geographic deaveraging. We therefore seek comment on the following questions:

Issue 14a: Should the Commission adopt density-based pricing zones as the relevant geographic market for assessing competition and granting regulatory relief under price caps? Should some other defined geographic area be used?

Issue 14b: If we condition the regulatory relief and pricing flexibility discussed in Section IV.B. on a demonstration of competitive conditions, should the relief and flexibility be allowed only in the geographic market in which the demonstration of competitive conditions has been made? How would this affect interstate toll rates? Should the relief and flexibility be permitted in an entire study area even if a demonstration of competitive conditions has been made only in a portion of the study area?

124. Parties supporting the use of density zones in this context should comment on whether these zones would be valid market definitions for all access service baskets and categories or only for specific ones. The original pricing zone definitions were based on traffic densities and cost characteristics for the trunking basket. The Commission assumed that LEC costs were likely to be the lowest and competition the most vigorous for trunking services in the zones with the highest amounts of trunking traffic. As a result, the zones may not be useful in defining relevant geographic markets for services in the traffic sensitive, common line and interexchange baskets. We also seek comment on whether different pricing zones should be established for different service baskets based on their particular cost characteristics or other criteria. In addition, only three different zone levels are used today. For some services, however, three pricing zones may not be adequate to reflect the differing states of competition. Should the number of pricing zones that a LEC can establish without additional scrutiny and justification be increased? Commenters advocating increasing the number of zones should address whether that would also increase administrative costs for LECs or the Commission. We also have some concerns over the configuration of zones. Reflective of the marketplace, the pricing zones for trunking services have developed in a

[180] *See* Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region (Mar. 1, 1995); Update to Ameritech Customers First Waiver Request (Apr. 12, 1995).

checkerboard fashion, rather than in contiguous geographic areas. Does this characteristic pose any significant disadvantage for defining geographic markets for our plan?

125. Another approach for defining the geographic market would be to use pre-existing, fixed geographic units, such as study areas, Local Access and Transport Areas (LATAs), or Metropolitan Statistical Areas (MSAs). LATAs or MSAs may be too heterogeneous to provide useful definitions of competitive geographic markets. There may or may not be some administrative benefit in defining markets as contiguous areas. Parties that believe that these fixed boundary geographic units should be used should explain what geographic units they recommend and how these units reflect a market for various access services.

126. Other possible geographic definitions have been proposed by participants to the *First Report and Order*. In its prior comments, USTA proposed defining the relevant market area by individual wire center.[181] According to USTA, the LEC wire center is the smallest geographic area to which a competitive market analysis can be applied; therefore, it would be the most precise geographic area for measuring competition. We recognize that USTA's proposal was developed some time ago. USTA may now support a broader definition. In any event we are disinclined to adopt a wire center definition because there it would create thousands of individual markets and impose substantial administrative burdens on both the industry and this agency. One possible solution would be to consolidate individual wire centers into geographic markets in some rational way, based on competitive considerations. Parties advocating a wire center approach for defining the market should address the administrative advantages and disadvantages of using wire centers for purposes of assessing competition. Is it feasible for us to evaluate competition in each wire center, and what, if anything, can be done to ease administrative burdens associated with that approach? Advocates of this approach also should discuss possible methods for combining them into economically meaningful and administratively reasonable units. Parties recommending consolidation of individual wire centers into geographic markets also should propose a procedural mechanism for determining the grouping of specific wire centers.

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[181] *See First Report and Order*, paras. 372-73.

V. STREAMLINED REGULATION

A. Background

1. General

127. As we previously noted, the competitive standards we propose for granting LECs streamlined regulation are more stringent than those we envision for the increased pricing flexibilities within the price cap plan we have proposed above. The competitive standards that we propose using for the latter focus on reducing barriers to entry to permit additional competition. Streamlined regulation would provide a LEC considerably more pricing flexibility than what we propose in Section IV, and we therefore propose to condition streamlining on a showing of actual competition.

128. Although the Commission has not yet "streamlined" any LEC services, as described in greater detail below, the Commission has granted streamlined regulation for AT&T services that we have found to be subject to substantial competition. The Commission's analysis of whether AT&T's services are subject to substantial competition rested on considerations of market share, demand responsiveness, supply responsiveness, and AT&T's pricing behavior. AT&T's tariff filings for services subject to streamlined regulation are filed on fourteen days' notice, are presumed lawful for purposes of tariff review, do not have to be accompanied by cost support (although the Commission may request it), and are no longer subject to price cap ceilings, bands and rate floors. Also, AT&T is permitted to offer individually negotiated customer contract rates for services subject to streamlined regulation, provided these contract rates are generally available to other similarly situated customers.[182] In view of the similarities between the structure of and purposes behind the AT&T price cap plan and the LEC price cap plan, we believe that the analytical framework that we used to streamline AT&T's services may be an appropriate method for relaxing our regulation of LEC price cap services.

129. Allowing the price cap LECs to file tariffs that are presumed lawful, on fourteen days' notice, and without cost support would not constitute an abandonment of this Commission's responsibilities. Where warranted, we can require carriers to come forward with cost information to support its proposed rates.[183] The advance review would provide us with an opportunity to suspend or reject tariffs where necessary before they go into effect. We would reject any tariff that we found on its face to conflict with a statute or an agency regulation or

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[182] *Interexchange Order*, 6 FCC Rcd at 5881, 5894, *recon.*, 6 FCC Rcd 7569 (1991), *further recon.*, 7 FCC Rcd 2677 (1992) Second Report and Order, 8 FCC Rcd 3668 (1993), *recon.*, 8 FCC Rcd 5046 (1993).

[183] *See, e.g., LEC Price Cap Order*, 5 FCC Rcd at 6822.

order.[184] In addition, we retain authority to institute at any time on our own motion investigations of LEC tariffs after they become effective and to declare tariffs unlawful, if necessary. We would also adjudicate in the complaint process claims of unlawful actions by the LECs.[185]

2. Criteria Used for AT&T in CC Docket Nos. 90-132 and 93-197

130. The analytical framework that the Commission applied to determine which of AT&T's services should be subject to streamlined regulation may prove applicable to LEC interstate access services. By way of background, in 1989, the Commission eliminated traditional rate-of-return regulation for AT&T and implemented a system of price cap regulation for most of AT&T's telecommunications services.[186] The basic structure of the AT&T price cap plan is similar to the price cap plan adopted for the LECs and shares many of its rules. To implement the AT&T price cap system, the Commission divided AT&T's services subject to price cap regulation into three separate baskets and defined a PCI for each basket. As under the LEC price cap plan, the PCI for each basket imposes a price ceiling for the services in that basket. In order for the Commission to determine whether rate levels exceed the PCI, AT&T must compute and file for each basket an API, which represents a weighted average of actual prices of the services within the basket.[187] Also similar to the LEC price cap plan, AT&T may change rates for services within each basket subject to limited scrutiny, provided that the weighted average of all those prices remains below the cap.[188] The tariff filing is presumed lawful and may take effect on 14 days' notice without extensive cost support data. If, however, the proposed rate change would cause a basket API to exceed the applicable PCI, AT&T is

[184] *See e.g.* American Broadcasting Companies, Inc. v. FCC, 633 F.2d 133, 138 (D.C. Cir. 1980); Associated Press v. FCC, 4498 F.2d 1095, 1103 (D.C. Cir. 1971).

[185] *See* Sections 205 and 208 of the Communications Act, 47 U.S.C. §§ 205, 208; *see also Interexchange Order*, 6 FCC Rcd at 5894-95.

[186] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Notice of Proposed Rule Making, 2 FCC Rcd 5208 (1987), Further Notice of Proposed Rule Making, 3 FCC Rcd 3195 (1988) (*AT&T Further Notice*), Report and Order and Second Further Notice, 4 FCC Rcd 2873 (1989) (*AT&T Price Cap Order*), Erratum, 4 FCC Rcd 3379 (1989), *recon.*, 6 FCC Rcd 665 (1991) (*AT&T Reconsideration Order*), *remanded sub nom.* American Telephone and Telegraph Company v. FCC, 974 F.2d 1351, 1353 (D.C. Cir. 1992).

[187] *See AT&T Reconsideration Order*, 6 FCC Rcd at 665-66, for an explanation of how the price cap index is calculated.

[188] In addition to setting limits on the aggregate rates within each basket, the Commission instituted rate bands to limit the range within which AT&T could raise or lower individual rate element prices each year without becoming subject to additional tariff scrutiny. *AT&T Price Cap Order*, 4 FCC Rcd at 3077, *citing AT&T Further Notice*, 3 FCC Rcd at 3440.

required to file the change on the statutory maximum notice period of 120 days and to provide a full cost-based showing for such filings.[189]

131. The AT&T plan does, however, differ from the LEC plan in substantial ways. The interstate services the LECs offer are primarily access services used by long distance carriers, whereas AT&T's services are intended primarily for end users. Accordingly, the LEC service baskets, organized around network functionalities, differ substantially from the AT&T baskets, which are organized according to end users services.[190] As originally established, the three baskets of AT&T services consisted of: (1) residential and small business services (Basket 1); (2) "800" number services (Basket 2); and (3) other business services (Basket 3).[191] In 1991, after concluding an examination of the state of competition in the interstate interexchange marketplace, the Commission determined that there is substantial competition in the provision of most business services in the long distance marketplace and modified the AT&T price cap plan by granting streamlined regulation to all of AT&T's Basket 3 services,[192] except analog private line services.[193] As discussed in further detail below, the Commission based its finding of substantial competition in part on its conclusion that the business services marketplace is characterized by substantial demand and supply elasticities that limit AT&T's ability to exercise market power in this market segment.[194] The Commission also relied on AT&T's pricing of business services under price cap regulation and unrefuted evidence that AT&T's market share was substantially lower in business services than it was in other markets.[195]

132. In the *Commercial Services Order*, the Commission found that AT&T's Basket 1 commercial long distance services are subject to substantial competition and that AT&T lacks

[189] *AT&T Price Cap Order*, 4 FCC Rcd at 3109-11.

[190] Also, unlike the LEC price cap plan, the Commission did not adopt sharing and low-end adjustment mechanisms for the AT&T price cap plan. The Commission believed that competition would serve as a similar check on AT&T's potential earnings. *AT&T Price Cap Order*, 4 FCC Rcd at 3144.

[191] *AT&T Price Cap Order*, 4 FCC Rcd at 3064.

[192] *Interexchange Order*, 6 FCC Rcd 5880, 5893-95, 5905. AT&T's Basket 3 services included ProAmerica; WATS; Megacom; SDN; other switched services; voice grade and below private line service; and other private line service. *Interexchange Order*, 6 FCC Rcd at 5881 n.4.

[193] The Commission retained price cap regulation for AT&T's analog private line services after finding that they are of diminishing importance in the marketplace and are consequently less subject to competition than other business services. *Interexchange Order*, 6 FCC Rcd at 5895.

[194] *Interexchange Order*, 6 FCC Rcd at 5887.

[195] *Interexchange Order*, 6 FCC Rcd at 5887.

unilateral market power in the provision of these services.[196] The Commission therefore concluded that there is sufficient competition among providers to justify moving AT&T's commercial services from price cap regulation to streamlined regulation.[197] Consistent with the approach followed in the *Interexchange Order*, the Commission's market analysis rested on considerations of market share, demand responsiveness, and supply responsiveness.[198]

B. Proposed Factors for Determining When Streamlined Regulation Is Warranted

133. Based on a review of the information currently available to us, we believe that increased competition for LEC services is inevitable. We seek comment on whether the analytical framework that the Commission applied in the *Interexchange Order* and the *Commercial Services Order* is a reasonable basis for determining which of the LECs' services should be accorded streamlined regulation. Specifically, we propose that a price cap LEC service be permitted streamlined regulation when such service is subject to substantial competition, based on considerations of demand responsiveness, supply responsiveness, market share, and pricing trends. We request comment on the relative importance of these factors and on any other factors that may be proposed.

1. Demand Responsiveness

134. Demand elasticity measures the sensitivity of quantity demanded to price changes. It indicates what the percentage change in the quantity demanded for a particular product will be following a one percent increase in the price of that product.[199]

135. In the *Interexchange Order*, the Commission's determination that customers of business services are to a large degree demand-elastic was based on evidence that these customers tend to be sophisticated and knowledgeable purchasers of telecommunications services who exercised their "buyer power" by soliciting competitive bids before procuring telecommunications services.[200] The Commission also found that AT&T's market share in the

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[196] *Commercial Services Order*, 10 FCC Rcd at 3011, 3014.

[197] *Commercial Services Order*, 10 FCC Rcd at 3014; *id.* at 3018 (permitting AT&T to offer commercial long distance services under streamlined regulation enables AT&T to enter into contracts with customers for these services).

[198] *Commercial Services Order*, 10 FCC Rcd at 3014. Unlike the Commission's approach in the *Interexchange Order*, however, the Commission's analysis in the *Commercial Services Order* was not based on AT&T's pricing of commercial services under price cap regulation.

[199] Robert S. Pindyck and Daniel L Rubinfeld, *Microeconomics*, Macmillan Publishing Company New York, 1992, p.29.

[200] *Interexchange Order*, 6 FCC Rcd at 5887.

business services segment was significantly lower than in other segments[201] and that AT&T's competitors had invested considerable capital in expanding their supply capacity and would not have done so if they were convinced that they would be unable to attract substantial numbers of new customers over time.[202]

136. In the *Commercial Services Order*, the Commission determined that AT&T's principal competitors provide a number of commercial services that are comparable to those offered by AT&T, and that customers are well aware of and make use of these alternative suppliers.[203] The Commission found that evidence indicating that approximately 23 percent of AT&T's commercial customers annually switch either from AT&T to another long distance provider or from another provider to AT&T annually provides "strong support for the argument that AT&T lacks market power over its customers."[204] The Commission concluded that fluctuations in AT&T's market share from 54 percent in 1987, to 39 percent in 1991, to 44 percent in 1993, corroborated evidence that commercial customers are significantly sensitive to price and quality changes.[205]

137. We believe that strong evidence of competition in the interstate access market exists where services comparable to those offered by the LECs are available to their customers, a significant number of those customers have the ability to evaluate the full range of market options available to them, and these customers do in fact exercise these options. We therefore propose that the demand responsiveness of the LECs' customers should be an important factor in assessing the level of competition for LEC services for purposes of determining whether a service should be accorded streamlined regulation.

Issue 15a: Should demand-responsiveness be a factor in determining the level of competition for purposes of determining whether services should be streamlined? What should be the relevant factors in determining whether a LEC's customers are demand-responsive? What data and information would be necessary and relevant in determining whether a LEC's customers are demand-responsive? Does the fact that LECs have relatively few customers that account for most of their interstate access demand affect the usefulness of demand-responsiveness as a factor in determining the level of competition?

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201 *Interexchange Order*, 6 FCC Rcd at 5887.

202 *Id.* at 5888.

203 *Commercial Services Order*, 10 FCC Rcd at 3016.

204 *Commercial Services Order*, 10 FCC Rcd at 3016.

205 *Commercial Services Order*, 10 FCC Rcd at 3015-16.

2. Supply Responsiveness

138. Supply responsiveness is a critical element in evaluating the level of competition for access services. As a conceptual matter, supply responsiveness or elasticity is measured using a parallel concept to that used for demand. It measures the percentage change in the quantity supplied resulting from a one percent increase in the price of a product.[206] A high supply elasticity indicates that entry is relatively easy and that any attempt by an incumbent to raise prices will result in new entry. Conversely, a low supply elasticity is indicative of market power.

139. Competitive response in the access market has two major sources. In the short run, competitors will respond to price increases by using existing capacity, while in the long run, new capacity will be built. A competitor's ability to utilize existing capacity in response to a price increase is measured by "addressability."[207] The presence of available, unused capacity of competitors is believed to constrain the exercise of market power by limiting the ability of dominant firms to raise prices above competitive levels.[208] Once competitive capacity is built and available, attempts by an entity to restrain output and raise prices will encourage alternative suppliers to increase production, thereby protecting the customers from the first entity's actions. Although addressability in principle measures available alternative capacity, it is unclear how it should be measured and whether adequate data are available to permit us to use it to evaluate whether competitive circumstances are sufficient to allow regulatory relief. Addressability also appears to be relative rather than absolute. In some cases, available capacity can be used immediately as a substitute for the incumbent's capacity and in other cases much longer periods are required before the capacity can actually be used to provide access services. There also are questions regarding how well some types of capacity can be substituted for other types and at what cost specific customers can avail themselves of alternative capacity. In the long run, competitive responsiveness will depend on the ease of entry and alternative technologies which permit new entrants to respond to price increases. Such entry will be vital in establishing a competitive market for access services.

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[206] Robert S. Pindyck and Daniel L Rubinfeld, *Microeconomics*, Macmillan Publishing Company New York, 1992, p.32.

[207] Addressability is narrower than supply elasticity. Supply elasticity measures both addressability (immediate ability of competitors to supply additional capacity if prices rise) and the additional capacity that could easily be added by competitors and new entrants as prices rise. USTA asserts that for a customer's demand to be addressable an alternative provider must have facilities that can readily extend services to the customer upon request. It states that a measure of addressability is based on observable fact -- the physical presence of alternative providers with the capacity and geographic coverage to serve a substantial portion of the market. USTA Comments, June 29, 1994.

[208] *See Interexchange Order*, 6 FCC Rcd at 5888-89.

140. In the *Interexchange Order*, the Commission's determination that supply elasticities in the interstate interexchange business services marketplace are high was based on evidence that AT&T's competitors had substantial excess capacity available immediately and in the relative short-term.[209] In the *Commercial Services Order*, the Commission determined that there appeared to be a high elasticity of supply among AT&T's commercial long distance competitors[210] based upon evidence that AT&T's competitors appear to have sufficient network capacity to serve a significant portion of AT&T's commercial long distance traffic and that AT&T's competitors have a proportionately greater supply of unused fiber capacity than AT&T.[211] Evidence that AT&T's commercial long distance traffic represented a small portion of the overall switched traffic and that other carriers could absorb all of AT&T's traffic provided additional support for the Commission's finding of high elasticity of supply among AT&T's commercial long distance competitors.[212]

141. We believe that supply elasticities of a LEC's competitors are important in assessing the level of competition for LEC services. We believe that sufficient excess or readily available supply capacities enable firms with relatively small market shares to be well-positioned to capture large numbers of their competitors' customers if their competitors choose to price above competitive rates.[213] We therefore propose that the relative supply capabilities of the LECs' competitors should be an important factor to be considered in assessing the level of competition for LEC services for purposes of determining whether a service should be accorded streamlined regulation.

[209] *Interexchange Order*, 6 FCC Rcd at 5888-89. Specifically, the Commission found that MCI and Sprint could immediately absorb as much as 15 percent of AT&T's business day traffic without any expansion of their existing capacity. The Commission determined that this capacity was in itself more than sufficient to constrain AT&T's pricing behavior insofar as this capacity could accommodate a substantial number of new customers. The Commission also found that Sprint and MCI together could add about 25 billion minutes of new capacity to their networks for a combined investment of about $600 million. *Id.*

[210] *Commercial Services Order*, 10 FCC Rcd at 3016.

[211] *Commercial Services Order*, 10 FCC Rcd at 3017; *id.* ("much of the network capacity owned by the long distance carriers is fiber optic technology"); *id.* (noting that in 1993, AT&T owned 47 percent of the total fiber miles while serving 60 percent of the minutes of use of the interexchange market, while, in contrast, all other interexchange carriers owned 53 percent of the total fiber miles while serving 40 percent of the interexchange market).

[212] *Commercial Service Order*, 10 FCC Rcd at 3017-18.

[213] *See Interexchange Order*, 6 FCC Rcd at 5888; *Commercial Services Order*, 10 FCC Rcd at 3017; *see also generally id.* ("competitors must be willing and able to serve a significant portion of AT&T's commercial long distance traffic in response to a price increase, but by no means all of its traffic, in order to deter a price increase").

Issue 15b: **Should supply-responsiveness be a factor in determining the level of competition for purposes of determining whether services should be streamlined? What should be the relevant factors in determining whether a LEC's competitors have enough readily available supply capacity to constrain the LEC's market behavior and inhibit it from charging excess rates? What data and information would be necessary and relevant in determining whether a LEC's competitors are supply-responsive?**

3. Market Share

142. In the *Interexchange Order*, the Commission found that AT&T's 50 percent share of the Basket 3 business services market was "a level that is not incompatible with a highly competitive market" and, hence does not by itself demonstrate that a firm possesses market power.[214] In the *Commercial Services Order*, the Commission determined that AT&T's 44 percent share of the overall minutes of use of commercial long distance services provided evidence of AT&T's lack of unilateral market power.[215] The Commission also found that the fluctuations in AT&T's market share indicated the "considerable" willingness of commercial long distance customers to shift between long distance service carriers and provided further evidence of AT&T's lack of unilateral market power.[216] In addition, the Commission found that the market size of AT&T's competitors relative to AT&T suggested that they have capacity to service a significant portion of AT&T's customers, should these customers desire to switch carriers.[217]

143. We believe that market share should be one factor, among others, to be considered in determining the level of competition in a given market for purposes of streamlined regulation. As discussed above, a high market share does not necessarily confer market power. A company that enjoys a very high market share will be constrained from raising its prices above cost if the market is characterized by high supply and demand elasticities.[218] We believe that an analysis of the level of competition for LEC services based solely on a LEC's market share at a given point in time would be too static and one-dimensional. However, while we do not propose to

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[214] *Interexchange Order*, 6 FCC Rcd at 5890 (footnote omitted).

[215] *Commercial Services Order,* 10 FCC Rcd at 3015.

[216] *Commercial Services Order*, 10 FCC Rcd at 3015. As noted *supra*, AT&T's market share fluctuated from 54 percent in 1987, to 39 percent in 1991, to 44 percent in 1993. *Id.*

[217] *Commercial Services Order*, 10 FCC Rcd at 3015. In comparison to AT&T's 44 percent share, MCI's share of this market in 1993 was 21 percent, Sprint's share was 13 percent, and all other long distance providers had a combined market share of 20 percent. *Id.*

[218] *Interexchange Order*, 6 FCC Rcd at 5887.

ignore market share data in assessing the level of competition for LEC services, we do propose considering market share in conjunction with other factors, including, but not necessarily limited to, supply and demand elasticities and pricing trends.

> **Issue 15c:** Should market share be a factor in determining the level of competition for purposes of determining whether services should be streamlined? If the Commission considers the relative market share of the LECs and their competitors as one factor in assessing the level of competition for LEC services, what data and information would be necessary to assess the relative market shares of the LECs and their competitors? What should be the relative importance of the market share of the LECs and their competitors in light of other factors incorporated into our analysis and on any other factors that may be proposed?

4. Pricing of Services Under Price Cap Regulation

144. In the *Interexchange Order*, AT&T's pricing of business services since the implementation of price cap regulation provided additional support for the Commission's finding of substantial competition in the business services segment of the long distance marketplace.[219] The Commission stated that none of AT&T's tariff filings for Basket 3 business services exceeded the price cap ceiling, and all but one of AT&T's Basket 3 filings were below the applicable upper service rate band.[220] The Commission determined that this pricing behavior for Basket 3 services reflected the competitiveness of business services.[221]

145. We believe that evidence that a price cap LEC is pricing services below the price cap ceiling over a sustained period of time may indicate that such services are subject to competitive pressures, particularly in markets with high supply and demand elasticities. Conversely, we do not believe that a LEC's lower-than-required pricing of services is necessarily a reliable measure of competition in a market without such high supply and demand elasticities. We therefore propose that evidence that a price cap LEC is pricing services below the price cap ceiling over a sustained period of time should be considered as additional evidence that such services are subject to competitive pressures in markets with high supply and demand elasticities.

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[219] *Interexchange Order*, 6 FCC Rcd at 5889.

[220] *Interexchange Order*, 6 FCC Rcd at 5889. The one Basket 3 tariff filing that was not below the upper rate band was an analog private line filing at the upper rate band. The Commission did not streamline the regulation of AT&T's analog private line services. *Id.* at 5889 n.88.

[221] *Interexchange Order*, 6 FCC Rcd at 5889.

Issue 15d: **Should we consider evidence that a price cap LEC is pricing services below the price cap ceiling over a sustained period of time as additional evidence that such services are subject to competitive pressures in markets with high supply and demand elasticities? If so, what is the competitive significance of a LEC's pricing below the price cap ceiling for such a period?**

5. Other Factors

146. Although we believe that the demand and supply elasticities are the most important factors to be considered in assessing the level of competition for LEC services for purposes of streamlined regulation, we invite comment and discussion on additional factors that we should consider in an evaluation of LEC competition, for example elimination of barriers to entry in the event it is not otherwise required.

Issue 15e: Should the Commission consider factors other than demand responsiveness, supply responsiveness, market share, and pricing behavior in assessing the level of competition for LEC services? If the Commission considers such other factors in assessing the level of competition for LEC services, what data and information would be necessary to assess the relative importance of these factors?

C. Contract Carriage

147. In the *Interexchange Order*, the Commission adopted rules permitting the interexchange carriers to offer services pursuant to individually negotiated contracts, but allowed AT&T to offer contract rates only for services found subject to substantial competition and accorded streamlined regulation.[222] The Commission required that all individually negotiated contracts offered by the interexchange carriers be made generally available to similarly situated customers under substantially similar circumstances so as to comply with the nondiscrimination provisions of the Communications Act.[223] The Commission found that allowing AT&T the freedom to enter into contracts with customers for services subject to streamlined regulation would benefit consumers without increasing the risk of anti-competitive or "other undesirable behavior by AT&T."[224] AT&T is required to file, at least fourteen days prior to the effective

[222] *Interexchange Order*, 6 FCC Rcd at 5897.

[223] *Interexchange Order*, 6 FCC Rcd at 5897.

[224] *Interexchange Order*, 6 FCC Rcd at 5899.

date of its contracts, a tariff based on the terms of the contract containing all information required under Section 203 of the Act.[225]

148. We propose to permit the price cap LECs to offer contract prices for access services that the Commission has found subject to substantial competition and are subject to streamlined regulation, provided the contract rates are made generally available to similarly situated customers under substantially similar circumstances. Permitting the price cap LECs to offer such contract rates would seemingly offer significant benefits for consumers without increasing the risk of anti-competitive, unreasonably discriminatory, or otherwise undesirable behavior by the LECs. Contract carriage would benefit consumers by allowing them to negotiate service arrangements that best address their particular needs. Moreover, by requiring individually negotiated contract arrangements to be made generally available to other similarly situated customers, other customers would be able to reap the benefits of these new, more specialized arrangements. Contract carriage would further benefit consumers by stimulating competition for such streamlined services. By allowing the LECs to offer customers the same types of contract services that the LECs' competitors may already be offering, contract carriage will expand customers' choices.[226] This, in turn, will likely result in better service options from all carriers. Contract carriage can promote efficiencies that the LECs will be able to share with their contract customers. Also, permitting carriers to offer contract rates to win business that they might otherwise lose to a competitor might result in lower prices for consumers.

149. We do not believe that our contract carriage proposal will lead to predatory pricing as such contracts must be made generally available and are typically long term. Further, as discussed above, predatory pricing is likely to occur only if a carrier can eliminate competition and continue to deter potential competitors from entering the marketplace. Once competitors have invested substantial sunk costs necessary to participate in the access market, the existence of those facilities will deter the incumbent from raising rates in the future. We also do not believe that a LEC could effect a predatory scheme without detection in light of our proposal that contract terms be made public. Nor do we think that our contract carriage proposal will present an undue risk of discrimination. First, we would require the price cap LECs to make its contracts generally available to similarly situated customers so as to comply with the Section

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[225] *Interexchange Order*, 6 FCC Rcd at 5897. Specifically, AT&T is required to file a tariff summarizing the contract and containing the following information: (1) the term of the contract, including any renewal options; (2) a brief description of each of the services provided under the contract; (3) minimum volume commitments for each service; (4) the contract price for each service or services at the volume levels committed to by the customers; (5) a general description of any volume discounts built into the contract rate structure; and (6) a general description of other classifications, practices, and regulations affecting the contract rate. *Id.* at 5902.

[226] Nondominant common carriers routinely file contract rates for interstate services. Tariff filings by nondominant common carriers are presumed lawful. *See* Section 1.773 of the Commission's Rules, 47 C.F.R. § 1.773.

202(a) nondiscrimination provisions of the Communications Act.[227] Second, contract carriage would only be allowed for services subject to substantial competition. Such competition would help to ensure that all customers purchasing services subject to streamlined review would receive just, reasonable and nondiscriminatory rates, regardless of whether the purchase is made pursuant to generic or contract-based tariffs.

150. With these considerations in mind, we request comment on the following issues:

Issue 16a: Should the Commission allow the price cap LECs to offer individually negotiated contracts for services subject to streamlined regulation, provided such contracts are made generally available to similarly situated customers under substantially similar circumstances? In particular, would allowing such contract carriage benefit consumer welfare, foster competition, and foster efficient use of the network? Would allowing such contract carriage result in unreasonable price discrimination?

Issue 16b: If such contracts should be allowed, what tariff filings requirements should we adopt for such contract rates? Specifically, should we require the LECs to file on 14 days' notice a tariff summarizing the contract and containing the following information: (1) the term of the contract, including any renewal options; (2) a brief description of each of the services provided under the contract; (3) minimum volume commitments for each service; (4) the contract price for each service or services at the volume levels committed to by the customers; (5) a general description of any volume discounts built into the contract rate structure; and (6) a general description of other classifications, practices, and regulations affecting the contract rate?

D. Procedural Matters

151. In this section we seek comment on what procedures the Commission should follow in considering whether a particular service in a given market should be subject to streamlined regulation outside the price cap plan. The level of competition for each LEC access service is likely to vary from one geographic market to another. We propose, therefore, that consideration of the transition of a service to streamlined regulation should be initiated by the filing of a petition by the LEC seeking streamlined regulation and that the petitioner shall have the burden to show that streamlined regulation is justified. We seek comment on what type of petition the LEC should file to seek streamlined regulation for a particular service in a given market -- a

[227] 47 U.S.C. § 202(a).

petition for waiver, a petition for a declaratory ruling or some other sort of petition -- as well as the procedures and standards which would apply in our review of the matter.

Issue 17: What procedure should be followed to implement streamlined regulation for a LEC?

VI. NONDOMINANT TREATMENT

152. As discussed above, we envision a three-part framework for our adaptive price cap regulation. In addition to providing certain regulatory relief within the price cap plan, and streamlining certain services out of price cap regulation, we would consider a LEC nondominant and forbear from price regulation to the extent permitted under the Communications Act where a LEC is shown to lack market power.

153. Currently, we define carriers as either dominant or nondominant in the domestic market as a whole. A carrier is classified as dominant if it has market power in the domestic market as a whole. We have not held that a carrier is dominant in the provision of some domestic services but not dominant for others.[228] Nor have we held that a carrier is dominant in one geographic market but not dominant in another.[229] When the Commission adopted this approach for determining market power, however, we explicitly recognized it as a "conservative approach to regulation."[230] After more than a decade of experience with this approach for determining market power, and with the advent of emerging competition in the interexchange access market, we believe a less encompassing definition of market power for LECs may be appropriate. Indeed, there appears to be no reason why a LEC should be considered dominant in any new geographic markets it may enter outside its traditional region. Moreover, we recently have received several petitions in which price cap LECs or their affiliates seek nondominant treatment for some services and geographic markets only.[231] For example, Bell Atlantic has filed a petition seeking regulation as a nondominant provider of interstate

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[228] *See* Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorization Therefor, CC Docket No. 79-252, First Report and Order, 85 FCC 2d 1, 22, n. 55, 24, n. 61 (1980) (*First Competitive Carrier Order*).

[229] We note, however, that we have held that AT&T is dominant in the provision of international message telephone service (IMTS), but is nondominant in the provision of non-IMTS services, *i.e.*, telex, telegram, TWX, private line, high and low speed data, videoconferencing and International Business Service. International Competitive Carrier Policies, Report and Order, 102 FCC 2d 812, 834 (1985), *recon. denied*, 60 Pike & Fischer 1435 (1986).

[230] *First Competitive Carrier Order* at 22, fn. 55.

[231] *See* Petition to Regulate Bell Atlantic as a Nondominant Provider of Interstate InterLATA Corridor Service (filed July 7, 1995) (*Bell Atlantic Interexchange Corridor Nondominance Petition*); Ameritech Communications, Inc. Petition for Nondominant Status, (filed July 21, 1995).

interLATA services in the corridor areas it serves.[232] We propose that a LEC be allowed to be regulated as nondominant with respect to a particular service and with respect to a particular geographic market.[233] We would permit nondominant carriers to file tariffs on one day's notice, and would not require them to submit cost support.[234]

154. Accordingly, we seek comment on the following issues:

Issue 18: Should we adopt rules now that would define the conditions LECs must meet to be considered nondominant? If so, should those conditions be what we used in *Competitive Carrier*, or some other conditions? Are there any reasons not to regulate a LEC as nondominant for some services and dominant for other services? Are there any reasons not to regulate a LEC as nondominant in some geographic markets and dominant in others? What procedure should a LEC follow to obtain nondominant status? What procedures would apply to a carrier that is determined to be nondominant?

155. First, we invite parties to discuss whether any LECs are likely to lose market power for any geographic and product markets in the foreseeable future, and if not, whether it is premature at this time to adopt rules governing nondominant local exchange carriers at this time. Parties who maintain that it is not premature to consider the possibility of LEC nondominance at some time in the future should provide support for their positions. Parties should also discuss whether there are specific services, such as services in the interexchange basket, for which LECs are likely to become nondominant sooner than others.[235]

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[232] *Bell Atlantic Interexchange Corridor Nondominance Petition.*

[233] *See* Section IV.D., *supra.*

[234] The Commission's Rules governing tariff filings by nondominant carriers, Section 61.20, *et. seq.*, of the Commission's Rules, 47 C.F.R. § 61.20, *et. seq.*, have been vacated. Southwestern Bell Telephone Co. v. FCC, 43 F.3d 1515 (D.C. Cir. 1995) (*Southwestern Bell v. FCC*). The Commission is currently in the process of revising its rules to conform to the court's decision. *See* Public Notice, Tariff Filing Requirements for Nondominant Common Carriers, 10 FCC Rcd 4074 (1995).

[235] *See First Report and Order*, para. 407 (discussing Bell Atlantic's and Ameritech's claims that their interstate intraLATA toll and corridor interexchange services should be removed from price caps).

156. Second, we solicit comment on the criteria that a LEC must meet to be considered nondominant in the provision of one or more services. In the *Competitive Carrier* proceeding,[236] we defined a "dominant" firm as one with market power; *i.e.*, the power to control prices or foreclose market entry. We used a number of criteria to determine whether a firm has market power, such as the number and size of competitors, the existence of barriers to entry, availability of substitute services, control of bottleneck facilities. We considered control of bottlenecks as *prima facie* evidence of market power. We also found that, in general, a firm or group of firms has control over a bottleneck when it has sufficient command over some essential commodity or facility in its industry to be able to impede new entrants.[237] In the *Competitive Carrier* proceeding, we concluded that we could "forbear" from applying certain tariffing requirements to nondominant carriers.[238] Although Courts later vacated our forbearance rules, they have not found our definition of dominance to be unreasonable. We have recently declined to revise the definition of dominance.[239] Accordingly, the standard for nondominance established in the *Competitive Carrier* proceeding appears to be one reasonable standard for determining whether the LECs have become nondominant. Parties supporting some other standard should explain in detail why the existing standard should not be used for this purpose and discuss why their proposal is preferable. If we adopt new criteria for determining whether LECs have become nondominant, should they apply to pending LEC petitions for nondominance?[240]

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[236] *First Competitive Carrier Order*, 85 FCC 2d 1; Second Report and Order, 91 FCC 2d 59 (1982), *recon. denied*, 93 FCC 2d 54 (1983); Third Report and Order, 48 Fed.Reg. 46,791 (1983); Fourth Report and Order, 95 FCC 2d 554 (1984) (*Fourth Competitive Carrier Order*), *vacated*, AT&T v. FCC, 978 F.2d 727 (D.C. Cir. 1992), *cert. denied*, MCI Telecommunication Corp. v. FCC, 113 S.Ct. 3020 (1993); Fifth Report and Order, 98 FCC 2d 1191 (1984); Sixth Report and Order, 99 FCC 2d 1020 (1985) (*Sixth Competitive Carrier Order*); *rev'd*, MCI Telecommunications Corp. v. FCC, 765 F.2d 1186 (D.C. Cir. 1985) (collectively, *Competitive Carrier*).

[237] *First Competitive Carrier Order*, 85 FCC 2d 1, 20-22 (paras. 55-59).

[238] Specifically, in the *Fourth Competitive Carrier Order*, we adopted "permissive detariffing," which permitted nondominant carriers to provide common carrier services without filing tariffs. In the *Sixth Competitive Carrier Order*, we adopted "mandatory detariffing," which required nondominant carriers to offer their services on an untariffed basis. In both cases, the Courts vacated our forbearance rules as inconsistent with Section 203 of the Communications Act, 47 U.S.C. § 203. *See* MCI v. FCC, 765 F.2d 1186 (vacating mandatory detariffing); MCI v. AT&T, 114 S.Ct. 2223 (1994) (vacating permissive detariffing).

[239] Specifically, when we adopted rules to govern tariff filings of nondominant carriers, we specifically declined to modify the dominant\nondominant regulatory dichotomy. Tariff Filing Requirements for Nondominant Common Carriers, CC Docket No. 93-36, 8 FCC Rcd 6752, 6754 (para. 8) (1993), *cited in First Report and Order*, para. 346.

[240] *See, e.g.*, Bell Atlantic Petition for Regulation as a Nondominant Provider of Interstate InterLATA Corridor Service, Public Notice, DA 95-1666 (rel. July 26, 1995).

157. Third, we solicit comment on the procedures that a LEC should follow to obtain nondominant status for provision of one or more services. Petitioners should discuss whether a LEC should file a petition for waiver, a petition for a declaratory ruling or some other filing and how the LEC should satisfy its burden of proof.

158. Finally, we request comment on the tariff filing procedures that should apply to a carrier that is determined to be nondominant.

VII. OTHER ISSUES

A. Other Changes to the LEC Price Cap Plan

1. X-Factor Flexibility

159. In the *First Report and Order*, we tentatively concluded that the long-term price cap plan should include more than one X-Factor. Because LECs are not uniform,[241] a single X-Factor might not reflect accurately the differences in economic circumstances faced by each LEC.[242] Establishing multiple X-Factors, however, may require us to develop a "matching" mechanism, so that each LEC is matched with the X-Factor that is most appropriate for its individual economic circumstances. We could either rely on a voluntary selection process, such as the one we are currently using in which LECs choose their X-Factor among various options, or a mandatory selection process in which we would assign each LEC an X-Factor through procedures established by the Commission. While there are a number of possible mechanisms in both categories, our discussion below seeks comment on those that rely on competition or additional pricing flexibility. Mechanisms that rely on other criteria and the larger question of whether we should use a voluntary or mandatory selection process will be addressed in a future further notice.

160. With respect to voluntary X-Factors, we invite comment on encouraging LECs to elect the appropriate X-Factor by permitting additional pricing flexibility for LECs electing higher X-Factors. We further invite commenters to explain the relationship between their responses to this issue and their responses above regarding relaxed regulatory treatment within the price cap plan and the triggers that might warrant each grant of regulatory relief.

161. With respect to mandatory X-Factors, we could use the level of competition faced by a LEC as a basis for assigning an X-Factor. We invite comment on whether we could base the X-Factor assignment for each LEC on the competitive circumstances faced by that LEC if we adopt mandatory X-Factors. Parties supporting or opposing this proposal should discuss whether the extent of competition has an effect on potential productivity growth. Specifically,

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[241] LECs vary, among other things, in business strategies, regional economic circumstances, plant vintages, state regulatory schemes and competitive circumstances.

[242] *First Report and Order*, para. 165.

they should address whether competition will decrease or increase productivity. As competition increases, productivity growth may decrease, as customers shift their demand from LECs to new market entrants, or, conversely, competitive pressure may provide a spur to increased productivity growth. In other words, should the higher X-Factors be assigned to LECs facing less competition or more competition? Parties supporting assignment based on competitive criteria should also discuss what X-Factor should be assigned given specific competitive criteria.

162. In this Notice above, we contemplate that we may provide regulatory relief in a geographic market that may be smaller than the LEC's entire service region, if the level of competition in that area warrants that regulatory relief. We invite comment on whether it would be possible or desirable to permit or require LECs to use different X-Factors in different parts of its service area.

Issue 19a: If we adopt optional rather than mandatory X-Factors, could we use relaxed regulatory relief to encourage price cap LECs to elect the X-Factor most appropriate for their circumstances? If so, what types of relief would most reasonably or most effectively encourage LECs to select an appropriate X-Factor? How is this issue related to the issues above regarding relaxed regulatory treatment within the price cap plan and the triggers that might warrant each grant of relief?

Issue 19b: If we adopt mandatory X-Factors, should we include considerations based on competitive circumstances in our assignment of an X-Factor to each LEC? Should the higher X-Factors be assigned to LECs facing less competition or more competition? What methods of measuring the extent of competition would be appropriate for this purpose?

Issue 19c: If we assign X-Factors to each LEC based on competitive criteria, would it be reasonable to establish different X-Factors for more competitive and less competitive areas in the LEC's service region?

2. Relaxation of Sharing Requirements

163. Growth in competition may also serve to reduce our need for a sharing mechanism if competitive pressures replicate some of the functions served by sharing. Consequently, we seek comment on whether it would be possible to permit LECs to decrease their sharing obligation as competition grows. By way of background, we established sharing in the *LEC Price Cap Order* to serve a number of beneficial purposes, including: (1) a "backstop" mechanism for the X-Factor, in case the X-Factors we establish turn out to be substantially in error or a particular LEC's productivity varies substantially; (2) a "flow-through" mechanism that ensures that a LEC's customers receive a portion of the benefits the carrier makes in

reducing unit costs; and (3) a "matching" mechanism to encourage LECs to elect the most appropriate X-Factor in a price cap plan with multiple optional X-Factors.[243] In the *First Report and Order*, we found, however, that sharing has a harmful side-effect in that it can blunt the efficiency incentives created by the price cap formula.[244] Therefore, we tentatively decided to establish a long-term plan that has at least one X-Factor without sharing requirements, and we established a long-term goal to eliminate sharing.[245] On an interim basis, we adopted three X-Factors but narrowed the non-sharing ranges and lowered the threshold at which 100 percent sharing would take effect for LECs choosing the lowest X-Factor. We also crafted the highest X-Factor option as a no-sharing option.

164. As each LEC faces increased competition for specific services, that competition will tend to force the prices towards cost. Eventually, the effect of this increased competition on prices may develop to a point such that it could replace the "flow-through" purpose of the sharing mechanism. Furthermore, it is possible that as LECs face more competition, their earnings will decrease, at least in the short run. If this is the case, then increases in competition at some point could replace the "backstop" purpose of the sharing mechanism.

165. We noted in the *First Report and Order* that NYNEX has proposed reducing or eliminating sharing for LECs that have implemented measures to promote local exchange competition and said that we would seek comment on NYNEX's proposal in this Notice.[246] NYNEX proposes to reduce sharing burdens as competition increases, and would measure competition by determining the percentage of lines in a study area that satisfy a list of competitive criteria.[247] Specifically, NYNEX proposes a four-tiered approach in which sharing burdens are lessened as competition increases.

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[243] *LEC Price Cap Order*, 5 FCC Rcd at 6801.

[244] *First Report and Order*, paras. 187-89.

[245] *First Report and Order*, para. 197.

[246] *First Report and Order*, para. 375. NYNEX discussed the details of its proposal in an *ex parte* statement it filed in this docket on March 3, 1995 (*NYNEX March 3 Letter*).

[247] The criteria on NYNEX's checklist are: (1) local exchange competition has been approved; (2) local loops have been unbundled; *i.e.*, a LEC's competitors may obtain access to the local loop directly, without purchasing local switching or other services; (3) intrastate expanded interconnection is available through tariff or contract; (4) there is number portability for use by competitors, *i.e.*, end users are able to switch local service providers and retain their current telephone number; (5) competing LECs have been authorized and/or have become operational; (6) there is some mechanism for the LEC and its competitors to compensate each other for completing telephone calls originated on each other's networks; (7) competitors have access to directory assistance and 911 databases; and (8) competitors are or have announced plans to collocate in wire centers which account for 40 percent of the incumbent LEC's business lines or 60 percent of its interstate access revenues. *See NYNEX March 3 Letter* at 4.